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February 22, 2011

Ms. Jennifer Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Ave, NW
Washington, DC 20551

Re: Docket No R-1404 and RIN No. 7100 AD63; Debit Card Interchange Fees and Routing

Dear Ms. Johnson:

Citizens Equity First Credit Union (CEFCU) has reviewed the Federal Reserve Board's proposed Regulation II, Debit Card Interchange Fees and Routing, and offers the following comments:

Sec. 235.3 – Reasonable and proportional interchange transaction fees

Activity Costs To Be Considered

We believe financial institutions should be able to offer a service to consumers at a price that covers its ongoing costs while providing a reasonable rate of return that is aligned with the amount of risk assumed. While the statute's philosophy and directive is built upon the apparent similarities of the debit card and check payment systems, the differences truly define the benefits of each to society and the economy at large and the resulting market price each party is willing to pay. Simply put, the party accepting the greater risk receives the greater reward. For example, merchants can accept a check payment with the knowledge that it may not be honored (high risk), but also knowing that the payor's bank only has one banking day to return the item (low risk). This allows the merchant to receive the "par" amount of the check (less processing costs charged by their depository institution, of course). In addition, if the check is not paid, merchants may charge collection fees to the consumer.

Contrastingly, the same merchant can choose to accept a debit payment knowing that, when authorization is provided at the point of sale, they are guaranteed (low risk) to receive immediate payment (high risk) from the card-issuer. Accordingly, the card-issuer is compensated for authorizing payment against an account balance but assumes the risk of insufficient funds when a completed debit transaction is received sometime within the next few days. As the Federal Reserve realizes, there are many more costs – such as operational and fixed expenses that are incurred for fraud losses, fraud prevention, dispute handling, data security, plastic and card issuance, customer service, network fees, technology, compliance, etc. – which financial institutions must bear to maintain the operations of this highly technical, efficient, and convenient payment system. All costs that are incurred as a direct result of offering a debit program should be considered in the Federal Reserve's cost measurement. Ultimately, financial institutions will not be able to support a debit card system that loses money. Costs that are not recovered through interchange will be transferred directly to the consumer.

Proposed Interchange Fee Standards

CEFCU urges the Board to adopt the interchange fee standard as proposed under Alternative 2 (Stand-Alone Cap) methodology. Although CEFCU would be considered “exempt” from these limits due to our asset size, this method results in the most efficient, and therefore least costly, means to apply the cap across all issuers. Alternative 1 introduces complexity, and cost, into the operations of card networks which, in turn, would be passed along to this credit union and all other small issuers.

However, as a small issuer, CEFCU certainly anticipates that the trickle-down effect will eventually occur – even with a two-tiered system, driving down the small issuer interchange fee to be on par with the large issuer fee. So, as the prices are going to be set by the government instead of free enterprise, we urge the Board to consider all costs, to the maximum extent allowed by the law, of operating a debit interchange system. The Board should also keep in mind that costs for small issuers will be greater than larger issuers simply due to the economies of scale large issuers realize in their operations and network contract pricing based on higher volumes. Also, we urge you to keep in mind that a low cap on interchange will stifle future research and development for technical enhancements that would improve operations and security of the system because there will be no incentive or revenue to put toward these efforts.

Sec. 235.4 – Adjustment for Fraud-Prevention Costs

We recommend the Board adopt a non-prescriptive standard for determining an adjustment to the interchange fee cap. Fraud prevention tools and their effectiveness vary among networks. In addition, supporting technology is very dynamic as enhancements are implemented and changes are made in response to criminal behavior. For this reason, any standard would be outdated before it was formalized. The various network fraud systems are not interconnected so establishing specific requirements would drive up costs for issuers who would have to invest in, or subscribe to, multiple fraud systems. Under the proposed network exclusivity Alternative B, this would double the amount of effort and cost required by card issuers. Issuers will likely scale back fraud prevention activities if costs are not reimbursed through a fraud adjustment.

Sec. 235.5 – Exemptions

Exemption for Small Issuers

CEFCU is very concerned that the fee cap exemption will not effectively protect small issuers. Without regulatory enforcement of a two-tier payment system, there is no mechanism in place to ensure smaller issuers aren’t negatively impacted either through network pricing or market forces. Merchants and large issuers will continue to have influence over the networks exerting pressure on the two-tier system, which itself is in conflict with the intent of the rule. We recommend the rules be clarified, and penalties added, to prevent merchants from discriminating against, discouraging the use of, charging a premium for, or refusing to accept higher interchange cards issued by exempt issuers. For the purposes of determining an institution’s qualification for exemption, the Board should allow the networks to develop standard certification processes.

235.7 – Limitations on Payment Card Restrictions

Prohibition on Network Exclusivity

We recommend that Alternative A be adopted requiring issuers to have at least two unaffiliated payment card network options available to merchants. This provides a choice to the merchant for routing transactions while creating less of a hardship on smaller institutions. CEFCU is concerned that requirements under Alternative B are onerous, unreasonably expensive, complex, and confusing to consumers. The technology to support two PIN networks and two signature networks does not exist today and the costs to develop these systems would be passed on to issuers and ultimately consumers. CEFCU agrees with the Federal Reserve’s interpretation that

the statute does not expressly require issuers to offer multiple unaffiliated signature and multiple unaffiliated PIN debit card network choices on each card.

No matter which alternative is adopted, there is not enough time to implement the proposals by their corresponding effective dates. It is a complicated process to add a network relationship to a debit card program that includes considerable due diligence, contract negotiation, coding and testing, card reissue, consumer education, and marketing. We suggest the implementation time frames be reasonably lengthened for either proposal if adopted.

Scope of Rule

CEFCU recommends ATM transactions be excluded from the proposed rules for the network-exclusivity prohibition and routing provisions because it reaches beyond the intent of the Durbin Amendment contained in the Dodd Frank Act. Treating ATM transactions as electronic debits and applying the proposed network exclusivity and routing provisions to these transactions will not provide any benefit to the consumer. In fact, additional costs to issuers to establish unaffiliated network relationships and increased interchange expense will ultimately pass to the consumer.

CEFCU also recommends that transactions on three-party arrangement networks should be consistent with the same interchange fee standards as transactions carried over the more traditional four-party networks. Otherwise, payment networks involved with a three-party network will hold an unfair advantage of receiving higher, unregulated interchange as compared to card issuers participating in an interchange-regulated four-party network.

In conclusion, CEFCU anticipates the main beneficiaries from the proposed rule will be merchants and the most harmed will be consumers. Issuers – caught in between – will be forced to pass on lost revenue and increased compliance expense to the consumer as a reasonable return on investment is required to maintain a viable ongoing business. The proposed rule does not appear to provide protection to consumers even though it falls under the Consumer Financial Protection Act of 2010. For these reasons, we have requested Congress to delay implementation to allow sufficient time for public debate, hearings and independent review. CEFCU urges the Board to delay implementation of the proposed rules in order to more thoroughly study their full impact on small card issuers, consumers and the overall economy. The Debit card payment system has become U.S. consumers' payment method of choice, making it alarming that such drastic regulation is about to be implemented without full knowledge of the consequences.

Thank you for providing us the opportunity to comment on this proposal.

Sincerely,

Todd Haller
Vice President, Electronic Funds Transfer